C.D. Howe Institute
Institut C.D. Howe

Backgrounder

June 29, 1999

A "Made for Ontario" Tax System: Promise or Threat?

by

Finn Poschmann

The campaign platform of Premier Mike Harris's recently re-elected Ontario government promised "to establish a 'made for Ontario' tax system, completely independent of the federal government's." The premier went so far as to write Prime Minister Jean Chrétien, "to explain Ontario's decision to join Alberta and Quebec in moving forward with its own tax system."

If "moving forward" means following Alberta's route, the premier is on to a good idea. An independent tax system for Ontario would be a sensible thing if it just means changing the base on which provincial taxes are calculated. But if the words are really intended to mean following Quebec out of federal-provincial tax agreements, that is quite another, expensive, thing, with costs to Ontarians that could easily exceed conceivable benefits.

What It's All About

Recent agreements among the provinces and the federal government have made it possible for provinces to make important changes to the way provincial personal income tax (PIT) is calculated. Provinces are now permitted to assess their PIT directly on taxpayers' taxable income, rather than charging it as a percentage of basic federal tax.

Alberta has been quick off the block, having announced its intention to make the switch by 2002. But Alberta is not bailing out of its existing tax collection agreement with Ottawa. While Alberta will have its own tax rate schedule and an independent nonrefundable personal credit scheme, most of its definitions and calculations will continue to depend on federal tax law, and Alberta taxpayers will continue to fill out only one combined tax return.

Changing the way provincial tax is calculated will prevent Albertan taxes from changing automatically with each future change in federal tax brackets and rates; Alberta will also be freer to choose how the burden of its taxes should be shared among its taxpayers. This level of independence will allow Alberta to establish a system of tax rates and credits that may suit local voters better than the federal

system, without imposing the compliance and administrative burden that a completely independent system would bring. On these grounds, Alberta's route should look attractive to Ontario policymakers.

Contrarily, Quebec has long had a tax system, "completely independent of the federal government's," that requires taxpayers to complete two distinct tax returns and the province to maintain its own army of PIT collectors. While this route offers more or less complete tax policy independence, the extra freedom that comes with leaving the tax collection agreements seems a small gain, especially when compared with the less-expensive option Alberta has chosen. With a small incremental benefit and a large incremental cost, moving to Quebec's level of tax independence seems like a poor bargain from Ontario's perspective.

If Ontario wants more tax policy choice without burdening its residents with huge administrative and compliance costs, Queen's Park should follow Alberta in launching a "tax on taxable income" initiative, rather than pushing for Quebec-style independence-with-a-price-tag.

The Tax Form Norm

Ontario, like eight other provinces, sets its PIT as a percentage of basic federal income tax payable (beginning in 2000, that rate is scheduled to be 38.5 percent, but with hefty surtaxes the actual average rate will be rather higher). The money due is actually assessed and collected by Revenue Canada — soon, the Canada Customs and Revenue Agency — and shipped to provincial governments under long-standing federal-provincial tax collection agreements.

The tax collection agreements allow most Canadian taxpayers to fill out a single income tax return. In every province but Quebec, most taxpayers follow a number of basic steps:

- Income from all sources is added together to arrive at total income.
- Particular expenses, such as registered retirement savings plan contributions or child care expenses, are subtracted from this amount in order to calculate net income.
- Capital losses and a few other deductions (such as for northern residents) are subtracted; the remainder is taxable income. Taxable income is the basis of the basic federal tax — which is calculated as 17, 26, or 29 percent of the amount by which taxable income exceeds specified thresholds.
- Nonrefundable credits are then calculated. This involves summing up personal and spousal amounts, and items such as Canada Pension Plan and employment insurance contributions, and multiplying the total by 17 percent.
- Nonrefundable credits are subtracted from the number that popped out of the federal tax calculation, leaving basic federal tax payable.
- Basic federal tax is then multiplied by applicable federal surtax rates and provincial income tax rates; most provinces also require taxpayers to calculate surtaxes on provincial income tax payable.
- Finally, the results of the tax and surtax calculations are brought together and netted against tax already paid (by way of source deductions, for example) as well as miscellaneous federal and provincial refundable credits.

Things are different in Quebec, which stands outside the federal-provincial PIT collection agreements. Quebecers fill out completely separate provincial and federal tax returns, because that province has its own way of calculating taxable income and its own graduated tax rate schedule to apply to that income.

The federal tax form Quebecers fill out is substantially the same as that used in other

103-00924

provinces. The separate Quebec tax form follows the same general pattern, but its details are not at all the same, and its definition of taxable income is subtly different. The standard Quebec form's four pages need to be completed using a number of worksheets (there is a 56-page guide), but taxpayers may have to complete as many as 13 schedules — again, in addition to any supplementary schedules required for the federal return. The Quebec form's reporting requirements, and the overall calculation, are about as extensive and detailed as those of the federal return.

Presumably, Quebecers are accustomed, or at least resigned, to the price they pay, in time and money, for having an independent PIT system. The collective choice to spend more on administration and compliance in order to maintain policy independence is one that Canadians, and particularly their provincial governments, have faced many times, and Quebecers are not alone in sometimes choosing the more expensive option.

Do Ontarians, however, wish to pay the going price for freedom in tax design, and how much is that price? Suppose 6 million Ontario taxpayers were to file separate federal and provincial tax returns in 2002 (5.4 million were filed in 1996). And suppose they value their time spent completing the new Ontario return at $40; alternatively, suppose $40 is the amount they pay professional tax preparers for completing the new forms. Moreover, suppose the Ontario government faces additional administrative costs of $30 per return to collect the tax. Thus, the additional cost of compliance and administration would come to more than $400 million per year for Ontario taxpayers, with few if any offsets from administrative savings in Ottawa — although Ontario tax preparers, lawyers, and accountants would see offsetting benefits. Almost all of that new cost could be avoided if Ontario were to shift to collecting tax on taxable income, rather than to adopting a fully independent tax system.

Western Trails for Ontario?

As noted, Alberta has decided to take immediate advantage of the newly established flexibility in the tax collection agreements. Beginning perhaps as soon as 2001, Albertans will calculate their provincial tax payable as a percentage of taxable income, as it appears on the federal income tax return, rather than as a percentage of basic federal tax. And while Alberta has proposed a distinctive turn — by making its schedule a single rate tax on income, rather than following the federal graduated rate system — the new mechanism will remain completely dependent on the federal *Income Tax Act*, and the province will remain within the tax collection agreements.

Alberta intends to follow a few general rules to keep its policy independence inexpensive. Most important will be the use of federally defined taxable income as the base on which tax will be levied, and Alberta has undertaken not to use refundable or other credits to rewrite the tax base. Ottawa will administer, free of charge, any supplemental provincial credits that mimic federal credits; if these credits are not harmonized with federal credits, Ottawa will charge Alberta the associated cost of administration. Ottawa will not administer tax provisions that are discriminatory toward nonresidents of Alberta or are otherwise illegal. By working within these constraints, Alberta will be able to deliver its version of an independent tax regime inexpensively and without requiring its taxpayers to fill out a separate return.

Alberta will be the first province to use a single-rate income tax as the basis for its PIT. The proposed rate is 11 percent, which would imply a net tax increase for low-income taxpayers (for whom the rate would otherwise be the 17 percent federal rate times the Alberta piggy-back rate, or about 8 percent) were it not for proposed large increases in the basic and spousal amounts. Because the personal amount ($7,131 federally) and spousal amount ($6,055 federally) are each to be set at $11,620 in

Alberta, low-income taxpayers will avoid tax increases. Another apparent selling feature of Alberta's flat tax is that it will reduce the difference in tax treatment between single- and dual-earner families.

In practice, it is likely that Albertans will fill out the provincial part of the form by simply copying over the total amount of nonrefundable credits from the federal part (without multiplying by 17 percent), adding an amount corresponding to the larger provincial nonrefundable credits, and multiplying the sum by 11 percent, with the result being the credit that is taken against provincial tax payable. Other accommodations will have to be made for dividend tax credits, taxpayers who report income from offshore or from other provinces, and for charitable donations. But solutions to these and other technical issues will be found through the coordinated efforts of Ottawa, Alberta, and the other provinces, and need not involve excessive compliance costs for taxpayers.

Ontario would do well to follow Alberta's example in disentangling federal and provincial tax calculations, clarifying who pays how much to what government and why, and straightening out the line of accountability between governments and the taxpayers who elected them. Ontario should not follow Quebec's relatively more expensive route, with its additional tax forms and calculations and far greater collection and compliance costs.

Whether or not Ontario's tax system should indeed be "made for Ontario," the Harris government can accomplish the underlying goal quickly and fairly cheaply, with comparatively minor fine-tuning to the system, so that the rate schedule and individual or family based credits follow a design suited to Ontario voters. Ontario should remain within the tax collection agreements and dependent on federal law for establishing what constitutes taxable income. This would be consistent with a view of federalism that allows regional determination of those policy priorities that are well suited to regional determination and that looks to national rules and standards only when they contribute to a better-functioning national polity and economy.

Backgrounder © is an occasional publication of the C.D. Howe Institute. Its purpose is to comment briefly on policy issues of immediate concern to Canadians.

As with all C.D. Howe Institute publications, the views expressed here are those of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors. Finn Poschmann is a Policy Analyst at the C.D. Howe Institute.

Copies of *Backgrounder* are available free of charge from the C.D. Howe Institute: 125 Adelaide Street East, Toronto, Ontario M5C 1L7 (tel.: 416-865-1904; fax: 416-865-1866; e-mail: cdhowe@cdhowe.org; internet: www.cdhowe.org).

Quotation with appropriate credit is permissible.